Audit's NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

December 27, 1973 SPECIAL BULLETIN

KASSUBA BANKRUPTCY: THE NEWS MAY BE WORSE THAN THE FACTS FOR TRUSTS

Walter J. Kassuba, the nation's third largest apartment builder last year with an estimated 6,000 unit volume, has sought protection under Chapter XI of the Bankruptcy Act while he seeks to work out an arrangement with unsecured creditors. The action was taken Dec. 21 after an unsecured creditor reportedly had received judgment for a $900,000 cognovit note in an Illinois state court.

According to our survey, 14 trusts hold approximately $135 million in various type investments with Kassuba and affiliated companies. Because the bankruptcy has received wide publicity, we are providing this special bulletin to summarize the impact of the action upon REIT shares generally and upon specific REITs.

Our first conclusion is that the bankruptcy news may be worse than the facts for most trusts involved. With over $500 million real estate assets involved, the Kassuba bankruptcy is by far the largest real estate bankruptcy since the widely watched failure of Webb & Knapp a decade ago. The complexity and scope of Kassuba's far-flung operations guarantee that the court action will affect nearly all mortgage lenders: over 200 mortgage lenders hold about 300 mortgages and leases on about 119 properties under construction or in operation with about 36,000 dwelling units.

For months the real estate fraternity has buzzed with reports about Kassuba's financial pinch but such rumors have been heard before with no apparent halt in the company's expansion. This year Kassuba strategy was to sell off some properties (the company asserts it has $100 million in equity in the properties) and numerous sales were in process. Nearly all were set for closing just before year-end so that tax-motivated buyers could claim tax benefits for all of 1973.

But the unexpected judgment on the cognovit note (a note in which the borrower confesses judgment and waives court notice) caught everyone by surprise. Too, some first mortgage lenders refused to consent to the sales, insisting upon the right to renegotiate interest rates. All this combined to force the company to seek Chapter XI protection.

Under Chapter XI, the debtor remains in possession of his business while he seeks an arrangement with creditors. In this case an arrangement is sought with unsecured creditors, mainly trade creditors, subcontractors and three commercial banks, because secured lenders already have real estate assets as security. Soaring interest rates are blamed for the company's cash bind, although materials shortages which delayed construction in some instances hurt.

The bankruptcy is likely to cut several different ways for the trusts holding investments, depending upon priority of their claims. In bankruptcy proceedings, first mortgage holders generally have priority over all claims except mechanic's and materialman's liens and IRS liens. The REIT lenders will generally look to the property for pay-

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ment of their investment. But REIT investments in our survey carry a variety of claim status, as follows:

	Mil. $	Percent
First mortgage standing or permanent loans	$43.863M	32.5%
First mortgage construction loans	28.794	21.3
First mortgage land and development loans	13.562	10.0
Subordinated land purchase/leasebacks	35.325	26.2
Junior mortgage and wraparound loans	13.538	10.0
Totals	$135.082	100.0%

Two holders of subordinated land purchase/leasebacks, Cabot, Cabot & Forbes Land Trust and Larwin Mortgage, said they would cancel leases to Kassuba properties and take possession. Others said they would study the situation further.

For REIT investors, the key question is whether the trust will stop accruing interest or lease payments on their investments. Again opinion was divided, with most trusts saying it depends upon various state laws plus later decisions by the Federal judge hearing the case. ICM Realty, with $9.6 million in six projects three and four years old, said it would not report income until the cash was received. Others like HNC Mortgage said it would continue accruing interest on the theory that rental proceeds from projects would be used to service debt obligations. Investments in uncompleted projects appear to be most vulnerable since they can be hurt by mechanic's and materialman's liens. We would avoid trusts with large amounts in the construction and land loan category shown below for the time being.

Because of these uncertainties, it is not possible to assess with any precision the ultimate earnings impact on individual trusts. The largest potential impact could be on earnings of HNC Mortgage, NJB Prime Investors, and First Wisconsin Mortgage. We stress these are potentials and actual impact cannot be judged fully at this time.

Of the investments shown below, First Mortgage reports about $11.7 million of its first mortgage permanent loans have been sold. Several other lenders believe some of their properties are in the process of sale, although the bankruptcy filing may have halted such sales. NJB Prime's subordinated land leasebacks are on nine projects completed in 1971, while ICM Realty's six land leasebacks are on Chicago area properties completed three and four years ago. Generally all are reported well rented, occupancies ranging from 70% to near 100%. Land loans are generally for second and third phases of completed projects. HNC Mortgage's largest investment is a $7.2 million standing loan on a completed apartment in Clarendon, Ill. Construction is reported halted at several of the projects with construction loans. The following table shows total trust investments, by type and individual trust, and Kassuba investments as a percentage of total assets (in millions of dollars):

		----------Kassuba Investments----------				
Trust	Total Invest.	Land/ Lease	Const. & Dev.	Perm. & Standing	Seconds & Wraps	Total	% to Kassuba
Berg Ent. RE	$22.6	$1.200	--	--	$0.615	$ 1.815	8.0%
Cabot C&F Ld.	155.3	1.000	--	--	--	1.000	0.6
Colwell Mtg.	132.8	--	$2.500	--	--	2.500	1.9
Diver. Mtg.	330.9	--	0.400	--	0.600	1.000	0.3
First Mtg.	650.0	--	15.000	$31.000	7.000	53.000	8.2
First Wisc.	186.1	--	10.375	0.196	1.623	12.194	6.6
HNC Mtg.&Rl.	122.0	--	5.215	9.267	2.600	17.082	14.0
ICM Realty	67.0	9.600	--	--	--	9.600	14.5
Larwin Mtg.	150.2	5.400	--	--	--	5.400	3.6
Mtg. Tr.Amer.	157.1	--	0.866	3.400	--	4.266	2.7
NJB Prime Inv.	83.2	10.500	3.600	--	1.100	15.200	18.3
No.Amer. Mtg.	214.2	--	4.400	--	--	4.400	2.0
Rlty. Inc.Tr.	65.4	3.750	--	--	--	3.750	5.7
Unionam.M&E	124.7	3.275	--	--	--	3.275	2.6
Arlen Prop.	52.1	0.600	--	--	--	0.600	1.2
TOTALS		$35.325	$42.356	$43.863	$13.538	$135.082	

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